EFRAG
European Financial Reporting Advisory Group

EFRAG's Public Consultation

Is there a need for specific financial reporting for long-term investing activities business models?

Responses should be sent to commentletters@efrag.org by 25 June 2013

Introduction and objective

1 The European Commission is consulting currently on a green paper considering possible ways for supporting long-term investment that is essential to European policy for economic growth. In its consultation, the European Commission alludes to the role accounting could play, questioning more particularly whether investments held with a long term horizon are best depicted when measured at fair value. In its role as advisor to the European Commission in financial reporting matters, EFRAG has decided to analyse more particularly the question raised by the European Commission, consult with European stakeholders and form a view.

2 Moreover EFRAG notes that the IASB has made an effort through the limited amendments to IFRS 9 proposals to identify a separate business model - the so called "held to collect and sell" model – for measurement and classification of financial instruments. A certain number of European constituents, among which the insurance and the long-term investment industries, have indicated that the IASB was heading in the right direction in its efforts to identify a third business model, but had failed to characterise it appropriately. Whilst EFRAG has finalised its comment letter in response to the IASB's proposals, EFRAG believes that unless more analysis is conducted, the IASB's efforts to improve IFRS 9 as originally issued may be a missed opportunity.

3 In this context, EFRAG has decided to launch this public consultation with the aim to:

(a) characterise, in the context of financial reporting, a "long-term investment" business model;

(b) determine whether this 'long-term investment' business model could be supported by an appropriate objective evidence and what the observable characteristics are;

(c) identify whether this "long-term investment" business model is similar to the business model followed by companies, such as insurance companies, pension funds or other long-term investment entities;

(d) analyse whether such business model would justify specific accounting to bring greater relevance in financial reporting.

4 This public consultation will help EFRAG:

(a) to contribute, in its role of technical advisor for financial reporting matters, to the European Commission consultation on the future of long-term investment;

(b) to better characterise long-term investment business models and contribute to accounting standard setting for such activities.

Follow-up from the IFRS 9 debate

5 In November 2012, the IASB published an exposure draft proposing limited amendments to IFRS 9 Classification and Measurement of Financial Instruments.

6 Following recommendations EFRAG had made in its participation to the IASB's due process[1], IFRS 9 had set the basis for a principle-based standard, making classification and measurement requirements depend on both the "characteristics of the instrument test" and on the business model. Financial instruments are to be accounted for at cost or fair value, and in the latter case, all changes in value are to be reported in profit or loss[2].

7 In its limited amendments, the IASB identified a so-called third business model – the "held to collect and sell" model. Such a model has been justified by the IASB because the level of sales compatible with the "held to collect" model might be too restrictive and because of the need to deal with potential accounting mismatches that would arise from insurance accounting. According to IASB's proposals, financial instruments that would both meet the characteristics of the instrument test and be managed under the "held to collect and sell" business model should be measured at fair value, while interest income and impairment losses would be reflected in profit or loss, and other changes in value and the offset of impairment losses would be reported as other comprehensive income items.

8 EFRAG's due process revealed that the IASB's proposals were rejected by many European constituents, while arguments for rejecting the proposals were diverse. From its communication with European stakeholders and its own analysis, EFRAG found that the IASB's proposals have been mainly rejected because they failed to characterise properly any business model and were therefore inconsistent with the original principles of IFRS 9.

9 Whilst EFRAG has finalised its comment letter in response to the IASB's proposals, EFRAG believes that unless more analysis is conducted, the IASB's efforts to improve IFRS 9 as originally issued may be a missed opportunity. Indeed a certain number of constituencies, among which the insurance and the long-term investment industries, have indicated that:

(a) the IASB was heading in the right direction in its efforts to identify a third business model although it had failed to characterize it appropriately;

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[1] EFRAG's comment letters on IASB's Discussion Paper "*Reducing Complexity in Reporting Financial Instruments*"; IASB's 2009 Exposure Draft "*Financial Instruments: Classification and Measurement"* and FASB's 2010 Exposure Draft "*Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities".*

[2] IFRS 9 provides an option to account for equity securities at fair value, however with changes in value presented in other items of comprehensive income, without any recycling in profit or loss.

(b) their business model would justify different financial reporting requirements from current IFRS 9, similar if not identical, to those proposed by the IASB.

EFRAG's initial analysis

10 EFRAG believes that reflecting an entity's business model in financial reporting may lead to greater relevance of financial reporting, provided that this is based on a robust analysis and not solely the reflection of a mere preference or an intended outcome. We note that this particular consultation is not directly linked to EFRAG's project on the role of the business model in financial statements. This consultation deals with only one possible application of the business model concept, aimed to discover whether there is an observable "long-term investment" business model, how it is defined and what implications for accounting purposes, not limited to those in IFRS 9, it might have.

Can a long term investment business model be characterised separately from a financial reporting perspective and be supported by appropriate objective evidence?

11 In its due process on the IASB's proposed limited amendments to IFRS 9, EFRAG has identified that the following issuers indicate conducting investing activities the business model of which could in their view justify specific financial reporting regime:

(a) long-term investment entities

(b) insurance companies.

However, this consultation is not limited to those two types of entities, but is rather open to all entities which are involved in long-term investment activities. Those two are only examples of entities which presented a fact pattern characterising a long term investment business model.

12 Those investing activities are primarily aimed at earning a return on assets, sales when they occur are aimed at optimizing the level of return or, eventually, at achieving a better matching of long-term liabilities. However, it may be that in certain circumstances similar investments are made with different economic objectives, for example to maintain a long-term relationship with the issuer of those instruments held. Although companies might have different economic incentives, the ultimate aim is to earn a return, no matter whether it could be related to an individual asset or holding, or only be identified at a higher level.

13 Those investing activities are not limited to investments in plain-vanilla debt instruments. They also involve investments in other financial assets such as equity instruments, or non-financial assets, such as investment property.

14 Management of those assets may be more or less active, be integrated in an asset-liability management activity or not, reflect different investing horizons. The amount and frequency of sales does not seem to be one of the major features of the business model, which may also involve instruments that end up being held up to maturity.

15 In launching its consultation EFRAG intends to assess the extent to which the description above is relevant to long-term investment activities from financial reporting perspective and whether such activities are identifiable for financial reporting purposes, i.e. supported by appropriate objective evidence.

Possible accounting treatments

The case for financial instruments

16 Currently IFRS 9 requires measurement at amortised cost and fair value through profit or loss[3]. IFRS 9 requires measurement at amortised cost if:

(a) no market transaction is necessary to recover the principal invested in the asset; and

(b) the asset does not create exposures other than interest and credit risks and the interest represents compensation for time value of money.

17 The assets are held in order to earn interest, which is recognised in profit or loss. Impairment losses are reported in profit or loss also.

18 Following these requirements leads to accounting for financial instruments held with a long term perspective at fair value. Those who support measurement at fair value believe that investors would not be fully informed if measurement on the balance sheet failed to capture all forms of risk exposure and/or to reflect that the asset will turn into cash through a market transaction. In a recent discussion held in London on 9 April organised jointly by the IFRS Foundation and ICAEW, for example, the IASB Chairman Hans Hoogervorst and Ugo Bassi, Director Capital and Companies Directorate at EC DG Internal Market and Services agreed that investing for the long term does not deprive from the need to have proper information on where one stands today. Some constituents also believe that use of fair value accounting is appropriate where entities manage matching liabilities on a fair value basis.

19 However others hold a different view. Some agree with the relevance of fair value measurement,however they consider that IFRS 13 current fair value measurement guidance would not necessarily lead to relevant estimates in certain circumstances. Some also argue that the requirement to produce fair value information may not be appropriate if there has been a significant decrease in the volume or level of activity for a particular asset or liability; EFRAG has previously acknowledged in its endorsement advice to IFRS 13 that some further standard setting effort may be necessary to further improve the standard. Some claim that the IAS 39 exception from fair value measurement for unquoted equity instruments when fair value cannot be reliably measured should be reintroduced in IFRS 9. The IFRS Foundation has recently issued educational material to accompany IFRS 13 *Fair Value Measurement* to cover the application of the principles in IFRS 13 when measuring the fair value of unquoted equity instruments within the scope of IFRS 9 *Financial Instruments*. Finally the use of models (as opposed to readily available market prices) when valuing financial assets at fair value has also been subject to criticism, more particularly in the absence of market inputs (level 3).

20 Others however believe that investments held as part of a long term investment strategy are best measured at cost. They argue indeed that short-term market variations are not deemed relevant in the reporting of a long-term investment entity's performance, even though they can be reliably measured.

21 Some would observe that the financial reporting regime proposed by the IASB in the limited amendments to IFRS 9 has the potential to bring consensus on how

[3] IFRS 9 provides an option to account for equity securities at fair value, however with changes in value presented in other items of comprehensive income, without any recycling in profit or loss.

investments held as part of a long-term investment strategy could be accounted for[4], provided that reliability concerns raised regarding fair value measurement in certain circumstances are dealt with. If this financial reporting regime is applied, investments are measured at fair value, however profit or loss reflects the effects of measuring those investments at cost, (interest income, dividends, less impairment) and the other changes in value are reported as other comprehensive income. Such a financial reporting regime has the potential of reconciling different views on the financial reporting of long-term investors since:

(a) It reflects in profit or loss a measure of performance based on cost that is deemed to best depict the business model of a long term investor, i.e. earning a return on assets, less impairment and its reversals;

(b) It reflects separately in other comprehensive income changes in value (all beyond costs) that have occurred in the period; the resulting reserve in equity reflects the outstanding cumulative gain since inception. For clarity purposes, this reserve can be identified within equity separately from retained earnings[5].

(c) It avoids accounting mismatches when assets and liabilities would otherwise be measured on a different basis, while the economic substance is to manage those assets and liabilities altogether on a long-term basis; as such performance reporting based on this economic substance would provide more useful information.

22 Disaggregation of changes in value between P/L and other comprehensive income items leads to question whether changes in value reported through OCI should be recycled through profit or loss. Those who oppose recycling believe that a change in value should be recognised only once. They also claim that allowing recycling of changes in value of equity or debt instruments that can be easily sold (i.e. more particularly quoted instruments) opens the door to earnings management.

However recycling is favoured by those who wish to see net income as a measure of performance based on the investment cost at inception. To meet this objective it is possible to require that outstanding gains when recycled through profit or loss upon derecognition of financial assets are presented separately in the income statement and disaggregated into the holding gain of the period and the recycled gains of the previous periods. This has the potential to cope with the identified risk of earnings management. However, such a risk can be considered as limited by the long-term perspective, in which high level of sales are not to be expected.

What model for impairment?

23 Extending to all financial assets the reporting regime proposed by the IASB in its proposed limited amendments to IFRS9 requires that IFRS 9 includes a second impairment model. Some believe this second impairment model should be based on the lower of cost or market. EFRAG has previously recommended this model because of its simplicity and its link to how the asset may be realised, i.e. through

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[4] The IASB has limited the application of this financial reporting regime to debt instruments that meet the characteristics of the instrument test. This limitation seems motivated by the perceived need to rely on one impairment model only, and not by any other reason.

[5] EFRAG notes that such a reserve can only reflect accumulated gains. It therefore cannot generate supplementary capital for regulatory purposes.

a market transaction. Allowing reversals keeps the performance reflected in profit and loss based on cost.

24 Others *believe that an impairment* model based on the lower of cost or market value is not appropriate for long-term investments, as in their view there is no rationale for recognising an impairment that is temporary in nature. Therefore they believe that the ultimate expected cash flows are the most relevant ones for long-term investments. Moreover in the circumstances where no market price is available and fair value should be marked-to-model, a discounted cash flow method may be used.

25 However, those who oppose this view argue that it is equally unsatisfying if fair value movements are not considered at all, as it might not faithfully reflect the financial position of the entity as of the reporting date, projected ultimate cash flows being potentially based on very subjective – and potentially imprudent – management's assumptions.

The case of other assets subject to long term investment strategies.

26 The discussion above has encompassed all financial assets, without having regard for the limitation the IASB has brought in its limited amendments proposals. One could question whether the discussion above should not be extended to other assets which are subject to long term investment strategies, such as investment property.

27 Those who would favour such a view would let the long term investment business model take precedence on the nature of the asset.

28 All non financial assets fall into the scope of IAS 36 for impairment purposes.

29 Through this open consultation, EFRAG aims to find whether a specific accounting treatment for investments held as part of a long-term investment strategy has the potential to bring more relevant information to investors and what that possible accounting treatment should be.

Questions to participants in the consultation

Question 1

Would you describe your (or one of your) business model(s) as a long-term investing business model? Please explain. If so, what is its economic purpose?

Question 2

What are your long-term investing activities driven by (e.g. the need to back long-term liabilities)? What is the nature of your long-term commitments? How do you distinguish between assets held to back long-term liabilities and other assets? Are you also involved in trading activities? If so, to what extent and for what purpose?

Question 3

What are the different types of assets you invest in?

Question 4

How is your long-term investment strategy established and how do you report on it, for both transparency and stewardship perspectives? How do you ensure that your current or potential shareholders can make the link between how you report your investment long-term strategy and the information provided in your financial statements? Could such a link be improved? How?

Question 5

Do you believe the business model described above justifies a specific financial reporting treatment? If so, what should it be? Please explain how it brings relevant information to investors. Are there circumstances in which you would argue that fair value is not an appropriate measure? What other measurement attribute would you suggest and why (i.e. where a measurement basis in existing IFRS does not properly reflect the business model as described by you)? How should measurement uncertainty be dealt with in a 'long-term investment activities' business model?

Question 6

If you are an investor in entities that are involved in long-term investment activities, what is the information that is the most relevant to you? How does IFRS financial reporting contribute to those needs today? Please explain.